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THE MONTANA CAPITAL COMPANY ACT

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A Report Prepared for the

Legislative Finance Committee

by

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August 3, 1990

OCT 17 2002

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EXECUTIVE SUMMARY

As part of the workplan for the 1991 interim, the Legislative Finance Committee directed staff to review Department of Commerce programs. This report examines one of the more costly economic development programs--the Montana Capital Company Act--to determine its effectiveness.

Enacted in 1983, the purpose of the act is:

> "...to encourage the formation of venture and equity capital in Montana for use in diversifying, strengthening, and stabilizing the Montana economy by increasing Montana employment and business opportunities."

The law allows a 50 percent credit against Montana income, corporation, or coal severance taxes for money invested in a qualified capital company. Capital companies must invest 70 percent of the funds for which tax credits were claimed in "qualified investments" within five years after designation as a qualified capital company.

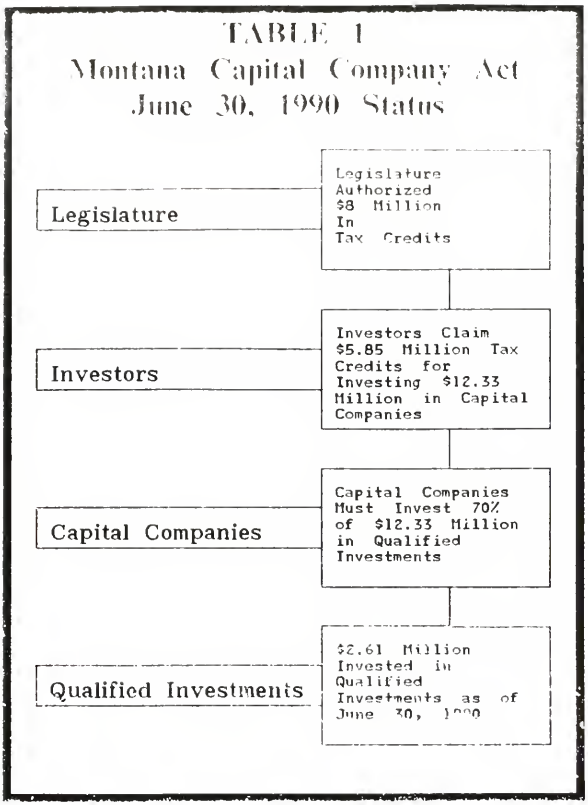
TABLE 1
Montana Capital Company Act
June 30, 1990 Status
Legislature
Legislature Authorized $8 Million In Tax Credits
Investors
Investors Claim $5.85 Million Tax Credits for Investing $12.33 Million in Capital Companies
Capital Companies
Capital Companies Must Invest 70% of $12.33 Million in Qualified Investments
Qualified Investments
$2.61 Million Invested in Qualified Investments as of June 30, 1990

To date, the Montana legislature has authorized $8 million in tax credits for this program. As of June 30, 1990, $5.85 million had been claimed by investors who invested $12.33 million in the qualified capital companies. In turn, these capital companies have placed $2.61 million in qualified investments in Montana. Board of Investments staff expect most of the $8 million in authorized credits will be claimed by the end of fiscal 1991.

The Montana Capital Company Act is a costly economic development program, compared to other economic development programs funded within the Department of Commerce. For the current biennium, the legislature has authorized a tax expenditure of $3 million in capital company credits. In contrast, the legislature appropriated $2.7 million in state funds for the biennium to fund the Business Assistance Division, which administers eight economic development programs, including the Pacific Rim Trade Office.

Determining whether the act has had a positive impact on Montana's economy is difficult because of lack of verified information and effective

state oversight of the operation of capital companies. Under current Board of Investments rules, capital companies are required to provide little information on qualified investments. No information is required on employment levels created and sustained because of the investment or on economic indicators reflecting the progress of the company in which the investment is made. The board's staff do not attempt to verify any of the limited information concerning the investments that is reported to them. While the Financial Division is required to conduct annual examinations of the "books and affairs" of all capital companies to "determine if the company is abiding by the purposes of the [act]" and that capital companies' funds have been invested within the required time limits, the division has conducted only two examinations during the seven years in which the act has been in effect. Both examinations were of the same capital company. These examinations were of limited scope and duration. There were: no on-site inspections of the companies in which the investments were made; no apparent attempt to determine whether the investments were "qualified" under statutory guidelines; and no attempt to evaluate whether the capital companies were having a positive impact on Montana's economy in accordance with the act's purposes. The division certified that a capital company met its 70 percent investment requirement, despite the fact that one investment may not have been "qualified" and 33 percent of the funds had been invested in companies that had declared bankruptcy prior to the division's examination.

Based on the available information, it appears that capital companies have had limited success in achieving their statutory purposes:

1) The credit is being claimed for investments that could have occurred in its absence. A significant portion of the funds invested in capital companies were available for direct investment in Montana's economy,

absent the credit. Fifty-eight percent of the qualified investment amount made to date has been in companies in which a capital company investor has an ownership interest. For example, five individuals invested $754,000 in a capital company, claiming $376,500 in tax credit. The capital company then invested $750,000 in a motel owned by the five investors. Several capital companies have received their capitalization from family members (and corporations in which family members have ownership) and have not sought investment from other sources. Investors in four closely-held capital companies have claimed $3.75 million in tax credits, 64 percent of those claimed to date under the program. The act may not be meeting its purpose if the credit is claimed for capital that was already available for investment and if capital companies are not encouraging capital information.

2) Several capital companies are not making higher-risk or venture capital investments. While the 50 percent tax credit was designed to provide an economic incentive for higher-risk investments, the majority of qualified investments have been made in businesses that commonly receive conventional financing. Of the $2.61 million invested to date, $750,000 was invested in a motel, $400,000 in transportation companies that had been operating for many years, $214,000 in a convenience store/gas station, and $75,000 in an existing cattle ranch. One capital company limits its investments to companies that have "recent history of operating profitability" and "an established track record". In such cases, the tax credit does not appear to be achieving its purpose: capital companies are able to offer investors both the incentive of a 50 percent tax credit and normal risk investments.

3) The success ratio of some of the qualified investments has done little to stabilize Montana's economy and create jobs and business opportunities. Of six qualified investments made by one capital company,

two--totalling $169,194--went bankrupt. Another major investment made by the same capital company has not made payments on its loans for over a year. Two of the three companies in which another capital company invested report no employees and are not listed in the 1990 telephone book. While some other investments appear to be more successful, fewer than 100 jobs have been created and sustained as a result of the $12.33 million invested in Montana capital companies to date.

The report suggests options for: 1) gathering more comprehensive data on capital companies' operations; 2) improving state oversight of their investments; and 3) maximizing their positive impact on Montana's economy.

Note: The data in this report is drawn from the capital company records maintained by the Board of Investments and the Financial Division. No information from individual tax returns was used in preparing this report. Since there is no language in the Montana Capital Company Act prohibiting public review of material relating to capital companies (including tax credit authorizations, quarterly reports, and annual examinations), the Executive Director of the Board of Investments has stated that "all the materials in our files and in our office concerning capital companies are available for public review."

While all reported information on capital companies is public, this report does not use names of investors, capital company stockholders, or individual investments, to insure that issues--rather than individuals--are the focus of the report. The report does list the individual capital companies, but does not identify specific investments or stockholders related to them.

OPERATION OF THE PROGRAM

Capital Companies

Under Montana's Capital Company Act, various types of organizations can apply to be qualified capital companies: any small business investment company; Small Business Administration (SBA) 503 corporation; local and community development corporation; development credit corporation, created pursuant to Title 32, Chapter 4; and "any profit or nonprofit entity... created for the purpose of making venture or risk capital available."

There is a two-step process for becoming a qualified Montana capital company:

1) Certification. The company must provide information to the Board of Investments[1] showing:
   a) its purpose is "to increase the general economic welfare of the state of Montana by making investment capital available to businesses in Montana";
   b) the proposed level of capitalization which the company expects to qualify for tax credits;
   c) it has disclosed to potential investors that:
      i) the tax credits are not available until the company raises at least $200,000 in capital and been designated a qualified capital company by the board; and
      ii) that the state of Montana is not liable for any damages to an investor in a company that fails to become

[1]From 1983-1987, the certification and qualification process was administered by the Montana Economic Development Board (MEDB). In fiscal 1988, legislation combined MEDB and the Board of Investments. The Board of Investments is now statutorily responsible for this process.

designated as a certified or qualified Montana capital company.

At the time it certifies a capital company, the board reserves a certain amount of tax credits based on the anticipated capitalization level of the company. Board rules allow a certified company one year in which to reach the minimum capitalization level ($200,000) and to use the reserved tax credits. If the company does not reach this level within a year, its certification and the reservation of the tax credits lapse. The board may, however, grant the company additional time to become qualified and use the tax credits. The board has approved several such extensions.

If tax credit reservations lapse, the board allocates the unused credits to the next qualified capital company, based on date of application.

2) Qualification. Once a certified capital company reaches a minimum capitalization level of $200,000, it may apply to the board for designation as a qualified capital company.

As the following table shows, since 1984, the board has certified 21 capital companies. Of these, four companies failed to reach the minimum capitalization level and their certification lapsed. One voluntarily requested decertification prior to qualification. Twelve capital companies have been designated as qualified and authorized tax credits totalling $5.85 million, as of June 30, 1990. Two of these qualified companies requested and were granted decertification, one after it completed its 70 percent investment requirement (see page 10). Another was de-certified by the board for "not operating in compliance with the Montana Capital Company Act."

Two companies that have been certified are seeking investors to reach the minimum capitalization level, thus becoming eligible to be designated a qualified capital company. Two additional companies have requested

certification. Since no tax credits are currently available, the Board of Investments has delayed their certification.

TABLE 2
Montana Capital Companies
Date of Certification and Qualification

	Date Certified	Date Qualified	Date Decertified
Development Corporation of Montana	2/84	3/84	6/90
Venture Capital Corp. of Montana	2/84	12/84	12/88
Blaine County Development Corp.	3/84		7/88
Montana Equities LTD Partnership	7/84		6/86
First Montana Capital Corporation	11/84	8/87	
Bitterroot Valley Development Corp.	9/85		7/88
Montana Capital Co.	9/85	1/86	1/87
Great Falls Capital Corporation	1/86	10/86	
Miles City Area Development Corp.	4/87		7/88
Southwest Montana Development Corp.	12/87	12/88	
CVM Montana Venture Fund I	5/88		7/89
Treasure State Capital LTD	5/88	8/88	
ECM Alpha LTD Partnership	6/88	Merged with Renaissance	
Renaissance Capital LTD	6/88	6/89	
Glacier Springs Company	7/88	1/89	
KBK Venture Capital Company	7/88	1/89	
Montana Progress Capital Company	12/88	1/89	
Big Sky Opportunities LTD	2/89	2/90	
Commercial Underwriters I	3/89		
CFI Venture Capital LTD	5/89	Merged with Mountain West Ventures	
Mountain West Ventures	5/89		
Bighorn Financial Corporation	Pending		
Terran Financial Group, Inc.	Pending		

Qualified Investments

To remain in compliance with the act, capital companies must invest 70 percent of the money received from investors claiming the tax credit in "qualified" investments. The act allows capital companies to invest in a broad range of qualified investments. The only type of investment that is specifically prohibited as a qualified investment is "conventional" oil and gas exploration.

The act defines a "qualified" investment as one that meets two criteria:

a) Is a small business. The act allows the Board of Investments to define small business. In rules adopted in 1983, the Board defines a small business as one with a net worth of less than $6 million; an average net income for the preceding two years of less than $2 million (after federal income taxes); and fewer than 200 employees working in Montana.

b) Is engaged in one of the following activities -- manufacturing; agricultural, fishery, or forestry production and processing; mineral production and processing (except for conventional oil and gas exploration); nonfossil forms of energy generation; transportation; research and development; tourism; or wholesale or retail distribution activities for which products produced in Montana comprise 50 percent or more of gross sales receipts. In addition, any business which derives 50 percent or more of its gross receipts from sales outside Montana is considered qualified.

The qualified investment does not need to be in Montana. The act allows a capital company to invest up to 25 percent of its capital base in a business outside Montana "if such investment is likely to produce a qualified investment in Montana." To date, no capital company has reported a qualified investment outside Montana.

The act prohibits a capital company from investing more than 50 percent of its equity or more than 25 percent of its capital base (the total funds raised for which tax credits were claimed) in one company.

Some capital companies would like legislation to broaden the list of "qualified" investments to include service industries--such as solid waste disposal--that provide in-state service only.

Schedule For Investments--Penalty For Noncompliance

The Montana Capital Company Act requires that a qualified capital company invest its capital base (the funds for which tax credit were claimed) in compliance with the following schedule:

a) at least 30 percent within three years of the date on which it was designated as qualified by the Board of Investments;

b) at least 50 percent within four years of this designation; and

c) at least 70 percent within five years of this designation.

If a qualified capital company expends its available tax credits and is granted additional tax credits by the board, its schedule for investment of the funds for which the additional tax credits are authorized begins on the date the board reserved the additional credits.

Board staff state that these schedules are designed to allow capital companies adequate time to find and make appropriate investments, while also ensuring that the funds were eventually used for qualified investments in accordance with the act's purpose.

The act makes the capital company, rather than the investor claiming the tax credit, liable if the company does not comply with this statutory schedule for investment. Section 90-8-203, MCA, provides that the taxpayer is not subject to penalties or recapture if the capital company fails to fulfill this statutory requirement. Rather, the capital company is subject to a penalty equal to all the tax credits allowed, plus 1 percent a month interest from the time the tax credits were allocated to the company.

The Department of Revenue may grant an extension of the time for making the investments and may abate the penalty for "reasonable cause".

To date, no capital company has had penalties assessed against it. The department allowed a three-month extension to one company to complete its required investments. In another case, the department determined that

the capital company was "not acting in a manner consistent with the purposes of the act" and negotiated the repayment of $75,000 in tax credits from investors. While the act says investors are not liable for the capital companies' failure, in this case the investors also owned the capital company.

Because the majority of the capital companies have only become qualified in the past two years, few companies have yet reached the "benchmark" dates--3, 4, and 5 years--by which the specified investment levels must be attained. In the following table, the "benchmark" dates for each qualified capital company is shown. Under each year, the first number shown is the month by which the investment level must be reached. The second number is the percentage (30, 50, or 70 percent) of the company's capital base that must be invested by that date.

TABLE 3

Required Investment Schedule
Month/% of Capital Base in Qualified Investment

	1987	1988	1989	1990	1991	1992	1993	1994	1995
Development Corp. of MT	3/30	3/50	3/70						
Great Falls Corp. (#1)			10/30	10/50	10/70				
First MT Capital Corp.				8/30	8/50	8/70			
Great Falls Capital Corp. (#2)				12/30	12/50	12/70			
Treasure State Capital Ltd.					8/30	8/50	8/70		
SW Montana Development					12/30	12/50	12/70		
Glacier Springs						1/30	1/50	1/70	
KBK Ventures						1/30	1/50	1/70	
MT Progress						1/30	1/50	1/70	
Renaissance						6/30	6/50	6/70	
Big Sky Opp.							2/30	2/50	2/70

The theory in requiring capital companies to invest only 70 percent of their capital base was that 30 percent would be needed for administrative costs. In addition, interest earned on the capital base prior to its placement in qualified investments is not included in the "benchmark" calculations.[2] As the following table shows, capital companies can earn substantial interest on the capital base during the period before it is invested in qualified investments. For example, a capital company can earn $1.6 million in interest on a $3.0 million capital base during the five year

[2]In 1985, the legislature amended the act to require "retained earnings" on the capital base be included in the 30 percent, 50 percent, and 70 percent benchmark calculations. However, the 1989 legislature removed this requirement. Sponsors of this change argued that requiring a portion of "retained earnings" to be placed in qualified investments made payment of dividends and liquidation of the capital company difficult.

period before the qualified investments must be completed. With the 30 percent that may be reserved for administrative costs, the capital company can retain $2.5 million for administrative costs/profits on a $3 million capital base over the five year period.

TABLE 4

Example of Interest and Administrative Funds Available to Capital Company

Capital invested by those claiming the tax credit		$3.0 million
Administrative Funds Available		
1. 30% Reserved for Administrative Costs		$0.900
2. Interest Earned on Administrative Reserve (5 years)		$0.574
3. Interest Earned on Capital Base Before Benchmark Investments		$0.984
30% for three years	$0.310	
20% for four years	0.291	
20% for five years	0.383	
Total Interest and Administrative Reserve		$2.458
Assumptions: 10% interest rate, compounded quarterly Capital base invested until benchmark date $3 million capital base available when company qualified		

This example illustrates a near-maximum amount of interest that could be earned on the capital base. A lower amount would be earned if the capital company:

1) is not fully capitalized when it becomes qualified;

2) spends the 30 percent reserve or accumulated interest for operations. Most capital companies use a portion of the reserves and interest for this purpose.

One capital company argues that the investment schedule is too short and may force capital companies to relax their investment criteria in order to meet the 3, 4, and 5 year "benchmarks". This capital company recommends that the investment schedule be extended beyond the five year benchmark.

Tax Credit

Under the Montana Capital Company Act, an investor can claim a tax credit equal to 50 percent of the amount invested in a qualified capital company. This credit can be applied against the Montana income, corporation, or coal severance tax. The total amount of the credit claimed by an investor may not exceed $150,000.

The tax credit must be used in the year in which the investment is made. If, however, the amount of the credit exceeds his tax liability, the investor may carry the credit back for the three preceding taxable years and forward for the next 15 tax years until the amount of the credit is exhausted.

This tax credit is substantially greater than other credits offered under Montana or federal tax law, as the following table shows. Other credits have lower rates, lower upper limits, and/or allow no carry forward or backward of the credit.

TABLE 5

State and Federal Tax Credits

Selected Credit	Rate	Limit/Investor
State		
Investment Credit	5% of Allowable Investment	$500
Elderly Homeowner/Renter	0-100% of Tax/Rent Paid	$400
New/Expanded Industry	1% of New Wages Paid	
Capital Company Credit	50% of Investment	$150,000
Federal		
Child/Dependent Care	20-30% of Allowable Cost	$1,440
Targeted Jobs Tax Credit	40% of $6,000 Qualified Wages	$2,400/Employee
Investment Credit	10% of Allowable Investment	

The 50 percent tax credit can eliminate or substantially reduce a taxpayer's state tax liability for many years. For example, an individual who invests $300,000 can claim the maximum $150,000 tax credit. This will eliminate the income tax due on a taxable income (income after all deductions and exemptions) of more than $1.35 million for one year. If the investor has less taxable income, he can use the credit over an 18 year period. So, an investor with a $150,000 credit and a taxable income of $90,000 per year could use the credit to eliminate all state income tax liability for an 18 year period. A corporation claiming the maximum credit for a single year would eliminate its state corporate tax liability on $2.2 million of taxable income. If the corporation used the credit over the maximum period, it would pay no corporation tax on taxable income totalling $123,457 per year for 18 years.

The credit can be particularly attractive for a married couple, under a recently adopted Department of Revenue policy. The department does not require couples who make a joint investment in a capital company to split the resulting credit equally on their tax returns (if they file separately). The department allows the couple to allocate the credit in any manner between the separate returns, provided the total credit claimed by a single investor does not exceed $150,000. The department does, however, require the couple to use the allocation method chosen in the first year the credit was claimed on all subsequent returns.

The size of the credit appears to have a direct bearing on investors' interest in Montana capital companies. When the Montana Capital Company Act was passed in 1983, the amount of the credit was 25 percent of the investment and the total credit that could be claimed was $25,000. The 1987 legislature increased the credit to 50 percent of the amount invested, and the upper limit on the credit to $150,000. This change appears to have sparked investor interest. As the following table shows, only 10 percent of the investment to date in capital companies occurred when the credit was 25 percent.

TABLE 6

Amount of Tax Credit Claimed Under Montana Capital Company Act, FY84-FY90

	Total Amount Invested	Tax Credit Claimed
25% credit	$ 1,246,300	$ 311,575
50% credit	11,080,352	5,540,176

The 1989 legislature further amended the act, allowing the credit to be claimed by a trust or an estate and allowing the credit to be applied against the coal severance tax. Supporters argued that this would increase

the amount of capital available for investment in the state. To date, no investment tax credits have been claimed against the coal severance tax.

The 1989 legislature also added language clarifying that no individual, partnership, or corporation could claim more than $150,000 in tax credits. Prior to this time, the act limited the credits that could be claimed from a single capital company to $150,000 per individual, partnership, or corporation, but was silent on whether this limitation applied to investments in more than one capital company. The Department of Revenue interpreted this language to mean that the $150,000 limit applied only to investment in one company--an investor could claim an unlimited amount of credit, provided that no tax credit from an investment in a single company could exceed $150,000.

The 1989 amendment further provided:

> "A corporate taxpayer that obtains the maximum $150,000 credit may not obtain additional credits through investments by wholly owned subsidiaries or affiliates".

In the administrative rules implementing this amendment, the Board of Investments has defined "affiliates" in accordance with Internal Revenue Service regulations. Under this definition, one family and 44 corporations in which family members have ownership interest have formed and invested in two capital companies, claiming $3 million in tax credits--over one-half of all the tax credits authorized to date.

In recognition that "demands on state revenues restrict the financial ability of the state to make unlimited tax credits available," the legislature initially authorized $1 million in tax credits for the 1985 biennium and an additional $1 million for the 1987 biennium. The 1987 legislature authorized an additional $3 million in credits for the 1989 biennium and another $3

million in credits for the current biennium.[3] Any portion of credits that are allocated to qualified capital companies that are unused in a biennium can be carried forward to the next biennium[4]. To date, the legislature has authorized $8 million in tax credits for this program. As of June 30, 1990, $5.85 million had been claimed. Board staff expect most of the $8 million authorized in tax credits to be claimed by the end of the biennium.

Envisioning that there would be substantial competition for credits, the legislature through statute and the Board of Investments through rule has provided a mechanism for allocating available credits among qualified companies. At the time the board designates a capital company as certified, it reserves tax credits for the company based on: 1) the level of capitalization anticipated by the company; and 2) credits available under law. If the capital company does not secure sufficient investments to claim these credits within the allotted time, the board may authorize an extension or reallocate these credits to the next certified capital company, based on the order in which the companies' applications for designation as certified companies were received. At the present time, one company is on the waiting list for $286,751 in credits if other capital companies are unable to use their reserved tax credits within the year. In addition, two companies' are awaiting certification, pending available credits.

Table 7 shows the amount of credits reserved and authorized for each company.

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[3]A 1989 amendment to authorize an additional $3 million in tax credits for the 1993 biennium was unsuccessful.

[4]At the end of one biennium, $87,500 in authorized credits had not been allocated to a qualified capital company, so they could not be carried forward into the next biennium. For that reason, the total amount of capital company credits that can be claimed by the end of this biennium is $7,912,500 of the authorized $8 million.

TABLE 7

Tax Credits Reserved and Authorized
As of 6/30/90

	Reserved	Authorized	Balance of Tax Credits Available	Reserved Credit Expires
Development Corporation	$184,075	$184,075		
Great Falls Capital Corp.				
#1 Authorization	127,500	127,500		
#2 Authorization	690,500	690,500		
First Montana Capital Corporation	100,000	100,000		
Glacier Springs Company	650,000	650,000		
KBK Venture Capital Co.	105,000	105,000		
Montana Progress Capital Company	1,500,000	1,500,000		
Big Sky Opportunities LTD	1,500,000	1,500,000		
Treasure State Capital LTD	1,213,249	652,500	$ 560,749	8/90
Southwest Montana Development Corporation	241,176	241,176		
Renaissance Capital LTD	101,000	101,000		
Mountain West Ventures	1,000,000	0	1,000,000	11/90
Commercial Underwriters I	500,000	0	500,000	9/90
Total	$7,912,500	$5,851,751	$2,060,749	
Tax Credit Waiting List: Treasure State Capital	$ 286,751			

At least one capital company plans to seek legislation during the 1991 legislative session authorizing additional tax credits during the 1993 biennium.

While the Board of Investments had issued certificates to individuals and corporations authorizing them to claim $5.85 million in capital company credits as of June 30, 1990, Department of Revenue records show only $1.86 million of credits has been claimed on tax returns through calendar year 1989. Since credits in excess of tax liability can be carried forward for up

to 15 years, the remaining $3.99 million in authorized credits will be claimed in future years. Through calendar year 1989, 370 individuals had claimed tax credits totaling $1.39 million against their individual income tax and 173 corporations claimed $0.47 million in credits against their corporation tax. To date, no credits have been claimed against the coal severance tax.

Public Investment

The tax credits are not the only investment of public--or public employee--funds in Montana capital companies.

In 1989, the legislature amended the Montana Capital Companies Act to authorize the Board of Investments to purchase capital company debentures (unsecured loans) with the in-state investment (coal trust) funds. To date, the board has not purchased any capital company debentures.

The board did, however, in 1985 invest $324,000 in funds from the Teachers Retirement System and the Public Employees' Retirement System in a qualified capital company. With this investment, the board owns 24 percent of the capital company's stock and was given a seat on its board of directors. To date, the investment has not generated any return. In 1989, the Board of Investments voted to write down the original investment by 25 percent.

Since the Montana Capital Company Act provides no funding for the Board of Investments' costs of administering the act, the board has absorbed administrative costs within its appropriation, which is funded by interest earned on the retirement funds, coal tax trust, and other investments. Since there is no separate appropriation for the program, the board has not kept records on the cost of its administration, but the

executive director estimates that staff spend approximately 5 days a month on the program.

The board is planning to propose legislation that would impose a fee on capital companies based on capitalization level. Revenue from this fee would be used for the board's administrative costs.

MEASURING THE EFFECTIVENESS OF THE ACT

The statutory purpose of Montana's Capital Company Act is "to encourage the formation of venture and equity capital in Montana for use in diversifying, strengthening, and stabilizing the Montana economy by increasing Montana employment and business opportunities." While the act has been in effect for seven years and investors have claimed $5.85 million in tax credits, it is difficult to measure how successful the act has been in meeting these goals for several reasons:

1) lack of regulatory review, verified information, and systematic evaluation of the impact of the investments on Montana's economy; and
2) inherent difficulties of evaluating economic development programs.

Lack of Regulatory Review and Verified Information

The Montana Capital Company Act divides regulatory authority for the act among three state agencies.

Board of Investments

Under the act, the Board of Investments is responsible for:

1) designating capital companies as certified and qualified;

2) receiving quarterly reports from each qualified capital company regarding investments made in the capital company and investments made by the capital company;

3) authorizing tax credits upon proof that a capital company has received investments and providing investors with a certificate that must be filed with tax return;

4) providing the Department of Revenue with quarterly information on investors and tax credits authorized; and

5) preparing an annual report to the Revenue Oversight Committee on the operation of the program.

According to the board's executive director, board staff concentrate their efforts on: a) determining whether the companies meet the statutory qualifications for certification and qualification; and b) allocating available tax credits. The board's staff do not:

1) review or verify the information submitted on the quarterly reports concerning qualified investments. For example, they do not check whether the investments reported were actually made; whether they are in companies meeting the statutory qualifications for qualified investments; or whether the jobs reported for the business exist and/or were related to the investment; or

2) monitor the effectiveness of the investments. The quarterly report forms designed by the board require capital companies to report only once on the qualified investments made--when the investment is made. No subsequent information is required on the company in which the investment is made--its employment levels, net worth, sales, or any other measures of growth.

In one case, a capital company filed a quarterly report on an investment made five years earlier. By the time the report was filed, the company in which the investment was made had already ceased operation. In addition, the investment did not appear to meet the statutory definition of a "qualified" investment. Board staff did not raise these issues with the capital company or the Financial Division. The Financial Division included this investment in certifying whether the capital company had completed its 70 percent investment requirement.

The board's executive director argues that it is the responsibility of the Financial Division to review investments to determine whether they comply with the purposes of the act.

Financial Division

The Financial Division, Department of Commerce:

1) is required to examine "the books and affairs" of each Montana capital company "at least once a year". "The examination must address the methods of operation and conduct of the business of the Montana capital company to determine if the company is abiding by the purposes of [the act] and that the funds received by the company have been invested within the time limits required for a qualified Montana capital company..." (90-8-313, MCA) The cost of the examination is to be paid by the capital company;

2) is required to notify the Department of Revenue "following each annual examination" if any capital company has not made the scheduled investments;

3) may decertify a capital company that is not in compliance with the act, seize its assets, and liquidate it. The division is required to decertify a company that has a penalty imposed on it for failure to invest in a timely manner.

While the statutory requirement to examine the books of each capital company annually has been in effect since 1983, to date the Financial Division has examined the books of only one of the twenty-one capital companies that have been certified and/or qualified during the period.

In its annual reports to the Revenue Oversight Committee, board staff suggested that these examinations would begin soon after companies were designated as qualified. For example, in its first report to ROC, board staff said, "The first audits of the three qualified capital companies by the State Board Examiner will occur during calendar year 1985." In fact, the first audit occurred in June 1988 and the second in January 1990. Both audits were of the same capital company. In December 1989 (six and one-half years after the act became effective), the assistant administrator of the

Financial Division wrote in answer to a capital company's questions regarding operation of the act that the division:

> "...has not been very active in examining capital companies. This is an unfamiliar area to us, and results in some of these answers being vague or speculative."

There has been no examination of four capital companies who have reported $2.1 million in qualified investments since 1987. One capital company reached its 30 percent "benchmark" (by which 30 percent of its capital base must be placed in qualified investments) on October 31, 1989. To date, there has been no examination of the company.

As the table below indicates, three companies have similar "benchmark" dates (by which 30 percent, 50 percent, or 70 percent of the capital base must be met) in calendar year 1990 and five companies in calendar year 1991. As of mid-June 1990, the Financial Division had no schedule for completing these annual examinations.

TABLE 8

Dates by Which Benchmark Investments Must be Met

Year	No. of Capital Companies with "Benchmark" Dates
1987	1
1988	1
1989	2
1990	3
1991	5
1992	8
1993	7
1994	5
1995	1

The focus of the two examinations completed to date seemed to be whether the company had met the statutory schedule for investment, not whether the investments met the statutory criteria for qualified investments or accomplished the purposes of the act. Neither examination mentioned the number of jobs created by the investment or their impact on "diversifying, strengthening, and stabilizing the Montana economy." In fact, one examination certified that the company had invested 69 percent of its capital base, despite the fact that two of the qualified investments had already become bankrupt and ceased operation. These companies accounted for 33 percent of the capital company's "benchmark" calculation.

The division's examinations were relatively short, each consuming less than two staff days. There was no evidence that either examination included an on-site inspection of the companies in which the investments were made.

The administrator of the Financial Division concurs that the chief focus of the examinations is to determine whether the investment schedule is met. He said the examinations do not conduct on-site inspections to ensure that the companies meet the statutory criteria for qualified investments: i.e. that they sell 50 percent or more outside the state. He said the staff try to "infer" from the balance sheets of the business whether these criteria are met.

Department of Revenue

The Department of Revenue is required to assess a penalty if a company fails to meet the time-line. The department may abate the penalty if the capital company establishes reasonable cause for the failure and if the failure is not due to neglect on its part. A 1989 amendment allowed the

department to grant an extension for "reasonable" cause. Any penalty collected is deposited in the general fund.

While the department has not assessed a penalty against any capital company, it did negotiate the return of $75,000 in tax credits. While the statute specifically states that investors' tax credits can't be recaptured, in this case the investors were also the owners of the capital company. The department negotiated the return of tax credits in lieu of a penalty on the capital company.

In late 1989, the department allowed a three-month extension to a capital company to meet its investment schedule.

Securities Department, State Auditor's Office

Section 90-8-304, MCA, exempts Montana capital companies from the registration requirements of Montana's security law. Neither the salesmen soliciting investment in capital companies or the offerings made by the companies need to be registered with the Securities Department. However, the act does not exempt capital companies from anti-fraud laws, so investors could sue a company if they felt fraudulent claims concerning the proposed investments had been made or that the investments had been fraudulently handled.

Since the capital companies are not subject to registration, the Securities Department cannot:

a) specify what must be contained in the capital companies' disclosure statements to prospective investors. While the act requires capital companies to file disclosure statements with the department, it does not give the department authority to require changes in the statements. Securities' Department staff have informally told some capital companies that their disclosure statements were insufficient if later anti-fraud charges were filed;

b) regulate blind-pool offerings. In blind pool offerings, investors are typically not given information on the actual investments in which their funds will be placed. In regulated securities, the

department requires funds that will be used in blind pool offerings be held in escrow until the investments are made and limits the amount management can claim for "up front" administrative costs and profit. Since capital companies are exempt from registration, investors do not have this protection; and

c) register salesmen or broker-dealers soliciting investments in capital companies. The registration/license process for those selling other securities is designed to safeguard against fraudulent business practices.

In early 1990, Securities Department and Board of Investments staff became concerned that some capital companies might seek to become certified, even though no tax credits were available, to avoid the registration requirement. The Board of Investments voted not to certify any additional capital companies unless additional tax credits became available.

In summary, although three state agencies have some role in overseeing capital companies, in practice there is very little review of their operations, verification of information on the investments they make, and no systematic evaluation of the impact of these investments on Montana's economy.

Inherent Difficulties of Evaluating Economic Development Programs

Historically, states have had difficulty in evaluating the effectiveness of economic development programs. As a recent study[5] noted:

> ". . . assessment of [economic development programs] is not a simple task given the complexity of the economic environment, the lack of generally accepted performance monitoring procedures, or even the lack of generally accepted outcome measures."

Determining whether an action (such as a low-interest loan) taken under an economic development program was the factor that caused a business to relocate, a firm to expand, or jobs to be added is difficult.

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[5]The Urban Institute, Monitoring the Quality and Outcomes of Economic Development Programs, September 1989.

Similarly, it may be unfair to try to evaluate the effectiveness of an economic development program that has been in operation for only a few years, since it may take many years for the impact of any program to be felt on a state or local economy.

Impact on Montana's Economy

Final evaluation of the effectiveness of the Montana Capital Company Act may not be possible given: 1) the lack of regulatory review, verified information and systematic evaluation of the investments made; and 2) the inherent difficulty of evaluating any economic development program. However, an interim review of what the program has accomplished after seven years' operation and the authorization of $8 million in state tax credits may help the committee and the legislature evaluate needed changes and potential benefits of continuing or expanding the program.

The following analysis focuses on three issues. Has the Montana Capital Company met its statutory purpose by:

1) Encouraging the formation of venture and equity capital and investment of private capital?

2) Helping stabilize Montana's economy?

3) Increasing employment and business opportunities?

Has the Act Encouraged the Formation of Venture and Equity Capital and Investment of Private Capital?

Two issues were considered in analyzing this question:

a) Is the act encouraging investment of private capital that would not otherwise have been invested in Montana businesses?

b) Are the funds invested by the capital company being used for venture and equity capital?

There is evidence that some of the credits claimed under the act did not encourage investment that would not otherwise have been made. In 58 percent of the funds invested to date, the capital company invested in a

business owned by an individual who had invested in the capital company. For example:

1) An individual invested $20,000 in a capital company in December 1989, claiming a $10,000 tax credit. Within the next three months, the capital company lent $20,000 to a company owned 100 percent by that investor. Similarly, another individual invested $90,000 in the same capital company in June, 1989, claiming a $45,000 credit. Within nine months the capital company invested $65,000 in a business owned 100 percent by the investor. In another instance, the company in which the investment was made also invested funds in the capital company, claiming a tax credit. Five of the ten investments made by this capital company have been in companies in which an investor had a substantial interest. In three of the ten investments, the capital company had an ownership interest.

2) Five individuals invested $753,000 in another capital company, claiming tax credits totalling $376,500. The capital company then invested $750,000 of capital company funds in a motel owned by the five investors.

3) A third capital company has only one shareholder. He invested $200,000 in his capital company, claiming a $100,000 tax credit. To date, he has invested $47,000 of the capital company funds in a company in which he has 100 percent ownership, $30,000 in a company in which he has 50 percent ownership, and $50,000 in a company in which he has 30 percent ownership.

In these cases, the investor clearly had capital available. However, he chose to invest the funds in a capital company, becoming eligible for the tax credit, rather than invest directly in his own company. This suggests that the credit did not work as intended to encourage formation of venture capital. Instead, it may have resulted in the claiming of a tax credit for investment that would have taken place in its absence.

While some capital companies have sought to interest a wide variety of investors in the capital companies, thus encouraging formation of capital for investment, other capital companies are essentially family-owned and do not seek investment capital from other investors. Three companies which have sought capital from a variety of investors are the Great Falls Capital Company, which attracted 150 investors through a public offering; the Development Corporation of Montana, which recruited participation from the

corporate and banking community throughout the state; and the Southwest Montana Development Corporation, which has 215 investors. In contrast, another capital company, which lists 13 family members among its 15 investors, stated in its application for certification that it would be funded by capital from family members and would not seek additional funds. Another capital company has received its entire capitalization from one person--the sole owner of the capital company. Two other capital companies have received their entire capitalization from family members and corporations owned by family members. Investors in these four closely-held capital companies have claimed $3.75 million in tax credits, 64 percent of those authorized to date under the program. When capital companies are funded primarily by their owners and do not seek outside funds, the act's goal of encouraging private investment for formation of venture capital may not have been achieved.

Are the funds invested by the capital company being used for venture and equity capital?

A majority of the qualified investments to date have not been in areas that appear to meet the definition of "venture capital":

> "...money used to support new or unusual commercial undertakings; equity, risk, or speculative investment capital."

The largest single qualified investment made to date ($750,000) was for a 45-unit motel that is part of a state-wide chain. Two other large investments were for the purchase of well-established transportation companies. As the following table shows, several other investments by capital companies have been in areas that have traditionally received conventional financing. These investments comprise 55 percent of the total amount of qualified investments made to date.

TABLE 9

Selected Companies for Which Qualified Investments Have Been Claimed

Type of Business	Amount of Qualified Investment
Motel	$ 750,000
Convenience Store/Gas Station	214,000
Taxicab Company	250,000
Delivery Service	150,000
Cattle Ranch	75,000
Total	$1,439,000
Percent of Total Qualified Investments	55%

Other "qualified investments" made by capital companies appear nearer the usual definition of venture capital: literary magazine, software development, pet product manufacturing. However, these investments comprise only a small portion of the "qualified" investments reported to date.

Providing venture capital does not appear to be the purpose of some of the capital companies. For example, the by-laws of one of the larger capital companies sets forth the following criteria for its investments:

--existing businesses with an established track record

--growth potential with an anticipated real growth rate in revenues

--recent history of operating profitability

In applying for certification, another capital company listed its chief areas of potential investment as: 1) construction of new or expansion of existing motels; and 2) construction of new or acquisition of existing convenience stores and gasoline outlets.

While the 50 percent tax credit was intended as an incentive to encourage higher risk investment, it does not appear to be accomplishing this goal in many instances. Investors are able to receive the benefits of a 50 percent tax credit and investments with a normal risk factor.

While capital companies generally do not appear to be investing in venture capital projects, several have fulfilled the statutory purpose of providing equity capital. A number of the qualified investments made by the capital companies have included an ownership interest in the business. In fact, one capital company's objective is to assume a 100 percent equity position in its investments. To date, it has purchased two existing businesses, becoming sole owner in both. Two other capital companies have taken minority ownership interest in some of their investments.

Have "qualified investments" helped stabilize Montana's economy by creating jobs in depressed areas, helping aging businesses modernize, or diversifying the economy?

While there is little verified information about the investments made to date, the available information suggests that many of the investments have not themselves been stable. Of six qualified investments made by one capital company, two--totaling $169,194 in investments for which tax credit was claimed--went bankrupt. Another major investment has not made payments to the capital company for over a year. Of the three investments made by another capital company, two report no employees and are not listed in the 1990 local telephone directory.

Other investments have been more successful. A furniture manufacturing concern which received funds from a capital company and a number of other economic development programs currently employs 59 people. Reports filed by the capital companies report that 20 people are employed in the motel and seven by the pet food manufacturer.

Has the act created jobs and business opportunities?

Table 10 shows the 220 jobs associated with the qualified investments, as reported by capital companies at the time the investment was made. However, there are serious problems with this data:

1) No Long-Term Data. Capital companies are required to report on qualified investments only once--when the investment is made. So, the data shown in the board's records (and in the table) is the employment at the time the investment is made. Since no subsequent reports are required, it is impossible to tell whether the employment continued, increased or decreased. The only follow-up information available is when a capital company makes a later investment in the same company. This has occurred in eight of the 23 qualified investments made to date. The results reported for these eight investments is not encouraging:

   -- No jobs are listed for two qualified investments, which received a series of loans from a capital company totaling $77,000 over the period 1987-1990.

   -- No growth in employment over a three year period is shown for another qualified investment, which received two loans totalling $125,000 in 1987 and 1989.

   -- The only reported growth was five additional jobs over a two-year period by a firm which has received $120,000 in capital company funding.

Several of the investments listed in the board's reports have ceased operation, reducing the amount of continuing employment associated with the credit by 40.

2) No Direct Link to Investment. The Board of Investments quarterly report form does not require capital companies to report the jobs created by the investment of capital company funds or layoffs averted. In fact, the form simply has a space for "Jobs", with no instructions for reporting. In several cases, the jobs reported were not created by the investment. For example, one capital company bought two existing business, continuing, rather than creating, the 24 jobs reported. In other cases, the number of jobs reported cannot be solely attributed to the capital company investment. One qualified investment received funding under a variety of public programs--SBA, the Community Block Grant Development, the in-state investment fund, and from a capital company. Since the investment made by the capital company comprised less than 10 percent of the total funding under these public programs, the entire employment of the company (51) cannot be attributed solely to the capital company investment.

3) No Verification. The only information on the number of jobs associated with the qualified investments is that reported on the quarterly reports filed by the capital companies. This is unverified information, since no state agency is currently checking whether these jobs were created as a result of the investment or whether they, in fact, exist.

Because of the flaws in the data, it is impossible to determine how many jobs and what business opportunities have been created as a result of this act. Based on the data that is available, it appears that fewer than 100 jobs were created and continue to exist as a result of the $12.33 million invested in Montana capital companies to date.

TABLE 10

Qualified Investments Reported, FY84-FY90

Business	Date of Investment	Amount of Investment	Jobs Reported	Comments
Health Club	8/84	$50,000	11	Closed
Manufacturing	9/85	75,000	12	Bankrupt
Marketing	12/85-6/86	94,194	14	Bankrupt
Furniture Manufacturing	3/87	52,000	51	Funding from SBA, CBDG, etc.
Computer Repair/ Maintenance	12/87-3/89	125,000	9	No growth in employees, 1987-89
Pet Products Manufacturing	6/87-3/90	120,000	7	5 additional employees in 2 years
Dental Equipment Manufacturing	3/90-6/90	50,000	23	Existing business
Mining Equipment Broker	9/87	30,000	0	0 employees from 1987-1990
Software Development	9/87-6/90	47,000	0	0 employees from 1987-1990
Taxicab Company	9/89	250,000	19	Existing business
Delivery Company	6/90	150,000	5	Existing business
Landscape Arch.	12/88-12/89	120,000	15	
Equipment Devel.	12/88-2/89	54,134	4	
Software	12/88-12/89	29,123	3	
Import	2/89	40,000	2	
Pipeline Testing	3/90	20,000	1	
Cattle Ranch	3/90	75,000	1	
Telecommunications	6/90	190,803	6	
Printing	12/89	5,300	2	
Equipment Mfg.	3/90	65,000	1	
Literary Magazine	12/89	5,000	1	
Convenience/Gas Store	6/90	214,000	10	
Motel	9/89	750,000	20	
Total		2,611,554	220	

THE FUTURE OF THE MONTANA CAPITAL COMPANY ACT

Lapsing of Credits-Requests For Additional Credits

Under current law, no additional tax credits can be issued after June 30, 1991. However, one capital company has indicated it plans to seek legislation during the 1991 session authorizing an additional $3 million or more in credits for the 1993 biennium. Currently, there are two capital companies on the waiting list for more credits. In addition, one capital company has expressed interest in having the maximum amount of the credit raised from $150,000 to $250,000.

In considering possible legislation authorizing additional credits, the legislature may want to consider whether expenditure of the funds through an existing state program may be more cost-effective in benefiting Montana's economy. For example, would an additional $3.0 million invested through the Montana Science and Technology Alliance or appropriated to the Business Development Division for technical assistance create more jobs and business opportunities than authorizing $3.0 million in additional capital company tax credits?

Options for Improving the Monitoring the Capital Company Investments

While under current law no additional credits will be available after this biennium, several portions of the act will remain in effect: 1) capital companies must continue to file quarterly reports; 2) state agencies will continue to have regulatory responsibilities; and 3) capital companies have "benchmark" dates by which qualified investments must be made through

1995. In fact, the majority of investments under the Montana Capital Company will be made during the next five years.

During this important period, the legislature may want to require that better information be gathered on capital company investments to allow evaluation of the effectiveness of this $8 million program. The legislature may also want to consider revising some portions of the existing act to ensure that it is operating in a manner most beneficial to Montana's economy. Following are some options for committee consideration in both these areas.

Better Information

As this report details, at present very little information on the operation of capital companies and their investment is available to the public and the legislature. This lack of information makes it difficult to evaluate the cost-effectiveness of the program. Some options for collecting better information are:

1) Revise the quarterly reporting forms. By changing their administrative rules, the Board of Investments could require capital companies to provide more data on the companies in which they invest. This data could include:

   a) Jobs related to the investment. While it may be difficult to prove that a job was added or a layoff averted by a specific investment, the capital companies could be required to report employment levels prior to the investment and at quarterly intervals thereafter. The report could also require reporting of assistance from other public economic development programs (such as SBA, CBDG, etc.) during the period that might have had an impact on these employment levels.

   b) Performance indicators, such as units manufactured, monthly sales, or new products developed. This would allow the legislature to monitor the economic health of the investments and assess their contribution to the stability of the local and state economy.

   c) Documentation that the company is continuing to meet the statutory requirements of a qualified investment. For example, a wholesale or retail distribution company would

have to show that during the quarter more than 50 percent of its gross sales were of products produced in Montana, in accordance with Section 90-8-104(5)(G), MCA.

2) Require quarterly reporting on all qualified investments. Under the board's current rules, capital companies report on qualified investments only once--when the investment is made. By administrative rule, the board could require that capital companies provide a quarterly update on all qualified investments until the capital company meets its 70 percent investment requirement. If the quarterly report contained the employment and performance indicator information outlined above, the legislature would be able to evaluate if the qualified investments were achieving the purposes of the act.

ISSUE 1: SHOULD THE QUARTERLY REPORTS CAPITAL COMPANIES FILE WITH THE BOARD OF INVESTMENTS BE REVISED TO GATHER MORE COMPREHENSIVE DATA ON INVESTMENTS MADE BY CAPITAL COMPANIES UNDER THIS ACT?

Option A: Recommend that the Board of Investments revise its rules to require that capital companies provide the following information quarterly for all qualified investments: the number of jobs related to the investment and continuing employment levels; performance indicators for all qualified investments; and evidence of continued eligibility of qualified investments.

Option B: Take no action.

More Effective Oversight of Capital Companies

At present, it appears that no state agency is exercising effective oversight of the operations of capital companies. The Financial Division is not fulfilling its statutory duty of annually examining the books of capital companies. The focus of the few examinations it has completed has been limited to calculating the amount invested, rather than whether the operation of the capital company is fulfilling the purposes of the act. One alternative might be to transfer oversight of the companies to staff that are administering a related program. Two such programs are:

Community Development Block Grant (CDBG) Economic Development Grants

The Business Development Division, Department of Commerce, is responsible for awarding approximately $1.25 million in CDBG federal funds annually to local governments for loans to local businesses. In awarding the grants, the staff do an analysis of the company to which the local government would loan the funds, including a fiscal analysis of the business plan, a market review of the proposed product, and a "due diligence" analysis of the company's management structure. After the loans are made, the staff monitor the company for a year or more to ensure that it is complying with the terms of the loan. Since one of the key CDBG criteria is the number of jobs created or layoffs prevented, the staff monitor employment levels to ensure the company meets its "job targets", the employment levels projected in its application. The staff also review financial statements for the companies at six-month intervals.

Montana Science and Technology Alliance

The Montana Science and Technology Alliance, Department of Commerce, is authorized to loan up to $7.5 million from the in state investment funds for seed capital project loans to companies:

> "(a) to assist in the development of innovative technology in the state by providing a source of capital to the technology-based entrepreneurial sector in the state's economy;
>
> (b) to provide financing follow-along management support for entrepreneurial companies in the state that are attempting to develop products or processes based on innovative technologies; and
>
> (c) to provide a liaison between entrepreneurial companies in the state and other investors in an effort to enhance the pool of capital available to technology-based companies in the state."

In making seed-capital loans, the staff determines that the project meets statutory criteria and reviews its financial plan and the project feasibility. After the loan is awarded, the staff monitor the investment closely, requiring monthly financial statements.

In both these programs, Department of Commerce staff are evaluating the operations of new and developing businesses and monitoring their performance. Combining administration of the Montana Capital Company Act with these existing programs could improve oversight of capital companies' operations and investments and increase coordination among the state's economic development programs. At least one company that has received a funding from a capital company also received a CDBG loan.

This combined administration could be limited to the financial examination/monitoring aspect of the capital company act or include the certification/qualification process now administered by the Board of Investments. During the 1989 session, one of the bills amending the Montana Capital Company Act proposed that the certification/qualification function be transferred from the board to the Science and Technology Alliance. Under the bill, the Financial Division would have continued to be responsible for examination of capital companies' books. Citing lack of staff, the Alliance was not eager to undertake this additional responsibility and the amendment to transfer the board's duties to it was stricken.

ISSUE 2. SHOULD STATE OVERSIGHT OF THE CAPITAL COMPANY ACT BE INCREASED TO ENSURE THAT IT IS MEETING ITS STATUTORY PURPOSE? IF SO, WHAT ARE APPROPRIATE MECHANISMS FOR PROVIDING THIS INCREASED OVERSIGHT?

Option A: Request the Financial Division to fulfill its statutory responsibility to examine the books of every capital company annually to ensure that it is operating in accordance with the purposes of the act.

Option B: Request the Department of Commerce report back to the Committee by October 1, 1990, on ways to increase the oversight of capital companies' operations. This report should include discussion of the advantages and disadvantages of combining administration of this program with other economic development programs and suggestions for other mechanisms to help ensure capital companies are meeting their statutory purpose in an effective manner.

Option C: Take no action.

Maximizing the Benefit to Montana's Economy

To ensure that Montanans receive the maximum benefit from the $8 million tax expenditure for capital company credits, the legislature may want to consider the options listed below as ways to accelerate and increase the investment of capital company funds in Montana businesses. While it may not be legally possible to retroactively change the statutory criteria for qualified investments or the investment schedule, Legislative Council attorneys state that such changes can be made prospectively for "benchmark" dates that occur and investments made by capital companies after the effective date of amendments to the act.

1) Ensure continued performance of qualified investments.

To date, the Financial Division has counted the value of the initial investment in a qualified investment in evaluating whether a capital company has met its requirement to invest 30-70 percent of its capital base in investments meeting the statutory requirements. The division has not taken into account the status of the investment at the time of the "benchmark" calculation: was the company in which the qualified investment made still operating? were the terms of the loan being met? what is the current value of the investment? Recently, the Financial Division determined that a capital company had invested 69 percent of its capital base requirement even though: two qualified investments (totaling $169,194) had declared bankruptcy and had been written down to $1 on the capital company books and a third qualified investment had not made any loan payments to the capital company in over a year. The Financial Division counted the initial $294,194 invested in these businesses in determining that the capital company had invested $496,194 (69 percent) in qualified investments.

If the calculation of 30 percent, 50 percent, and 70 percent investment were based on the value of the investment on the date of the benchmark,

it would ensure that the tax incentive claimed on the investment had been invested in viable businesses that were contributing taxes and employment to Montana's economy. However, such a requirement may cause capital companies to avoid higher risk or venture capital investments--the very investments the act was designed to encourage.

2) Revise criteria for qualified investment.

The current statute defining "qualified investment" is very broad, allowing investment in almost any type of business activity other than conventional oil and gas drilling. The statute allows purchases of existing businesses and investment in businesses that generally receive conventional financing to be invested as qualified investments. Moreover, the definition does not require that the investments create any jobs. Possible revisions to the criteria for qualified investments include:

a) *Exclude purchase of existing businesses.* If the investment simply continues the current operation and employment levels of an existing business, it would not be a qualified investment. The investment would qualify, however, if as a result of the investment, the business' activities, processes, or employment levels changed significantly.

b) *Manufacturing of value-added products only.* This would emphasize businesses that added value to Montana's natural resources. It would limit investment in service and wholesale/retail businesses.

c) *Create and sustain a specified level of employment.* Similar to the requirements for CDBG loans, the act could be revised to require qualified investments to show that the investment resulted in a specified number of jobs created or layoffs prevented and that this employment level would be sustained over a specified time period. If the company did not meet these goals, it could not be counted in the "benchmark" calculation of required investments.

3) Accelerate or increase investment in Montana economy

Currently, the act allows capital companies up to five years to invest 70 percent of its capital base. The remaining 30 percent and all interest earned on the capital base prior to placement in qualified investments is exempt from the benchmark calculation and can be used for administrative costs and profits. As shown on page 13, the 30 percent reserve and accumulated interest provide substantial funds for administration and profit--up to $2.5 million on a $3 million investment during this five year period.

The amount of capital company funds invested in the Montana economy would be invested more quickly or be increased if:

a) *The investment schedule were accelerated.* For example, the act could require that 30 percent of the capital company funds had to be invested within one year, 50 percent within two years; and 70 percent within three years. While capital companies may argue that it will be difficult to make good investments in this shortened period, a shorter schedule would ensure faster placement of the funds in qualified investments.

b) *One hundred percent of the capital for which tax credits were claimed must be invested in qualified investments.* This would ensure that 30 percent more capital company funds were invested in Montana's economy. The capital company could use interest earned on the capital base for its administrative costs. While capital companies may need to use a portion of the capital base for administrative costs during its start-up, by the fifth year interest earned on investments could be used to replace this "start-up" money as well as providing for ongoing administrative costs.

c) *Include the interest earned on the capital base in the 30 percent, 50 percent, and 70 percent investment requirement.* This would increase the amount invested by capital companies in the Montana economy.

ISSUE 3: SHOULD THE CAPITAL COMPANY ACT BE REVISED TO MAXIMIZE ITS POSITIVE IMPACT ON THE MONTANA ECONOMY?

Option A: Request the Department of Commerce to report to the Committee by October 1, 1990, on possible revisions to the Montana Capital Company Act that would increase its positive impact on Montana's economy. This report should include discussion of the options for revising the definition of qualified investments, the method of calculating "benchmark" investments, and requirements for amount of capital base and/or interest invested in qualified investments.

Option B: Take no action.

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